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In The
Supreme Court of the United States
October Term, 1987

VARIABLE ANNUITY LIFE INSURANCE COMPANY, *et al.*,

Petitioners,

v.

BEVERLY J. OTTO, INDIVIDUALLY AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, *et al.*,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF RESPONDENTS IN OPPOSITION

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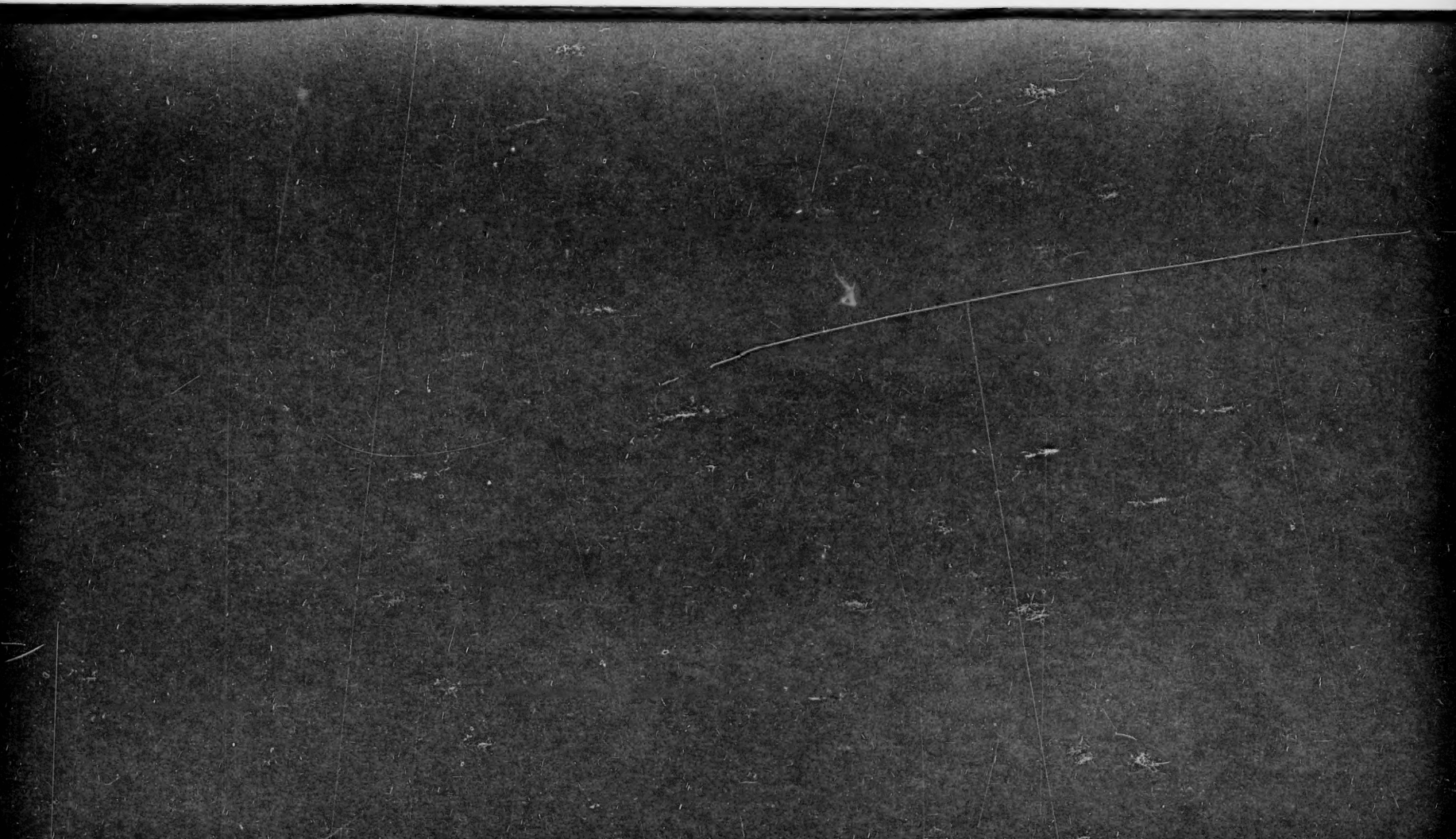

QUESTION PRESENTED

Whether the VALIC fixed annuity plan which is sold as a combination contract with an SEC registered security, the variable annuity, under the heading "A Tax Deferred Investment Program" consisting of a plan:

a) under which the investor bears the investment risk under SEC guidelines;

b) specially designed with unique investment features such as the option to freely switch back and forth from fixed to variable accumulation accounts;

c) which is not a traditional stand alone fixed annuity paying below market interest;

d) not regulated by the State of Illinois;

e) marketed with emphasis on discretionary competitive excess interest; and

f) sold by members of the National Association of Securities Dealers, not by insurance salesmen,

is a security subject to the coverage of the federal securities laws.

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OPINIONS BELOW

The opinions below are unanimous, both originally and on rehearing. There was no dissent nor was VALIC's In Banc rehearing granted.

In addition to the opinions listed by the petitioners, the order of the Court of Appeals dated January 29, 1987 is attached as Appendix A. This order, with its findings and directives, is as integral to the case on appeal as the opinions.

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STATEMENT OF THE CASE

This is a certified class action, the members of the class being all Illinois investors who participated in VALIC's fixed annuity plan/program. The Court of Appeals found that VALIC had misled (i) its customers (the plaintiffs herein); (ii) the district court; and (iii) the Court of Appeals. (For a discussion of the misrepresentations by VALIC see App.A.) It held that VALIC's "fixed annuity plan" was a security subject to the federal securities laws (814 F.2d at 1141). Defendants-Respondents are petitioning for certiorari as to this holding.

Plaintiffs-Respondents. The class that the named Plaintiffs represent is primarily comprised of school teachers, janitors, nurses, and other employees of non-profit institutions who invested funds in VALIC's "Tax Deferred Investment Program", of which the fixed annuity plan is a part. The program is tailored both to this particular class of buyers and to their use as retirement vehicles. The Plaintiffs-Respondents will be collectively referred to hereafter as "Otto," the first of the named Plaintiffs.

Defendants-Petitioners. The principal corporate Defendants are Variable Annuity Life Insurance Company (VALIC), an underwriting company, and VALIC's marketing subsidiary, Variable Annuity Marketing Company (VAMCO). VALIC is the same company whose variable annuity was held to be a security in *SEC v. Variable An-*

nuity Life Insurance Company, 359 U.S. 65 (1959) ("VALIC I"). The variable annuity, which was the only product sold by VALIC in 1959, is the backbone of the "Tax Deferred Investment Program" that is the subject of this litigation. The fixed accumulation account or fixed-annuity which the plaintiffs invested in was appended to the program in 1964. The Defendants-Petitioners will be collectively referred to hereafter as "VALIC," though, depending on the context, that name will also be used to identify only the Variable Annuity Life Insurance Company.

VALIC is in the business of issuing, among other things, an investment program which they have entitled a *Tax Deferred Investment Program.* The program was sold in Illinois by the marketing subsidiary of VALIC, VAMCO. VAMCO was not subject to regulation by the State of Illinois Department of Insurance as it was not licensed to do so. (By VALIC's own admission, its representatives should have been licensed.) (Pet., p. 4.) (VAMCO did not even qualify to do business in the state, though required to do so). Since the variable accumulation account is a security, all VAMCO sales people who sold the program had to be licensed National Association of Securities Dealers ("NASD") members. The class invested in this plan, with some class members allocating all their contributions to the "fixed annuity," and others pursuant to a VALIC option, splitting their contributions between the "fixed annuity" and the "variable annuity." Some class members actively switched their contributions between the two annuities.

Misrepresentations by VALIC concerning "banding of interest" and discretionary interest on "fixed annuity" deposits are the basis of this litigation.

Tax deferred plans. VALIC's investment program was designed to meet the special requirements of Section 403(b) of the Internal Revenue Code. Under this section, employees of public schools, private colleges, hospitals

and exempt charitable or educational organizations are able to put aside funds for retirement just as a profit sharing plan does in a profit making company. The Code permits employee funds to be invested in three types of accounts: mutual funds, custodial accounts, and annuity accounts. The investment contract sold by VALIC was designed to fall into the annuity category, although no traditional annuity was involved, only a deposit of funds for investment with and by VALIC.

The Tax Deferred Investment Program issued by VALIC is divided into two phases. In the first phase—the accumulation phase—the employee pays money to VALIC. This normally takes place through weekly or monthly withholding from his salary and the payment of the withheld amount to his account with the program manager, in this case VALIC. The funds were invested with VALIC, pursuant to its representation that it would pay the "highest current interest available" on all "fixed annuity" deposits.

Upon withdrawal from the plan for any reason—retirement, change of employer, or even because of a simple need for the money standing to his credit—the employee enters the second phase. In phase two—the pay-out phase—the accumulated amount is directed toward some end. In the VALIC program, either variable or fixed, the investor has four options. He can direct VALIC to (i) pay him the full amount; (ii) pay the full amount to the employee's IRA; (iii) continue to hold the funds and keep them invested; (iv) invest the funds in one of a variety of VALIC annuities. In other words, even if the investor throughout his earning years had allocated all his funds to the fixed accumulation account he could, on retirement, select the variable annuity, a security.

Prior to the purchase of an annuity by a participant, the relationship between VALIC and the investor was that of debtor and creditor. As stated by VALIC in its handbook (R.52, Ex.B):

> "Should you find it necessary to surrender your contract in the Fixed Account, VALIC guarantees to return the greater of the total cash value of your Fixed Account or your total contributions to the Fixed Account, less any prior withdrawals."

The mechanics of these programs are important for an understanding of this case.

VALIC's Description of its Fixed Annuity Plan. The foregoing described the VALIC investment program that is the subject of this litigation. VALIC has misrepresented its product to the court because it calls the fixed accumulation account of the "Tax Deferred Investment Program" a "traditional fixed annuity." (Pet., p. (i), passim) Not one of those terms is accurate. It was not an annuity; none of the named Plaintiffs ever received an annuity and it is doubtful that any member of the class did. It was not fixed; the amount of annuity depended on the amount contributed and on the earnings from the contributions—these earnings being almost totally within the investment discretion of VALIC, and on VALIC's unfettered discretion as to the amount of interest it would pay. It was not "traditional;" not only was it tailored to the specific requirements of the Internal Revenue Code for the unique use of schools, colleges, and other nonprofit organizations, but it contained an option to convert the contract from a return based on interest to a variable return based on market performance of investments. Such option on a security is itself a security (see Point B-1 of this brief). It did not resemble a traditional annuity at all.

In fact, VALIC admits in its Petition that the "traditional" fixed annuity that guarantees principal and a specified return without "excess interest" is rarely sold in the market today (Pet., p.19). As VALIC states in its Petition (at footnote 8 on page 18): "The fact that fixed annuities guarantee interest that is below market rates of return is thus an integral feature of this insurance product." VALIC did not sell the "traditional fixed an-

nuity" that it describes in its Petition. VALIC's literature describes its product as providing the "highest current interest available" (R. 174, Ex.I) and as an investment.[1] This is hardly the "traditional fixed annuity" marketed with below market interest rates they describe in the Petition, but rather an investment contract or type of money market account.

The VALIC Accumulation Accounts. During the accumulation phase a VALIC investor was given an option as to the investment of his funds. He could invest in the so-called "fixed" account or in the variable account (an admitted security), or in any combination of the two. Further, he could, without penalty, freely switch his funds from the fixed to the variable or from the variable to the fixed, and back again. As stated in the "Owner's Manual," (R. 52, Ex.B):

> "A Flexible Contract—Prior to retirement, you may exercise your option at any time to transfer any or all of your cash value from the fixed accumulation account to the variable accumulation account, or vice-versa, as the priorities of your total investment picture may change."

While funds invested in the "fixed" accumulation account were guaranteed an initial return of 4% a year, later dropping to 3½%, the real incentive was the *extra* interest that VALIC, in its unfettered discretion, could pay on the funds in the fixed accumulation account, as the Court of Appeals stated:

> "But VALIC's argument directly under the statute depends on its assertion that the guaranty of return here requires calling the instrument insurance under sec. 3(a)(8) *even if the prospect of 'excess' interest*

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[1] The Owner's Manual issued by VALIC emphasizes the investment results of the program: "Your funds are managed by investment managers who have the training, time, experience and necessary tools to manage your money professionally." "You may leave funds on deposit where they will continue to experience the appropriate investment result . . ." (R. 52, Ex.B).

is a principal inducement to purchase this particular instrument." (814 F.2d at 1142, emphasis added).

As VALIC notes in its Petition, a traditional "fixed annuity" has only a low guaranteed rate of interest which is below market because: "Such a limitation ensures that the guaranteed rate does not exceed what can be safely and reliably maintained over the life of the annuity." (Pet., p.18, footnote 8). In other words, a traditional fixed annuity which is rarely sold today imposes no investment risk on the issuer. During the period covered by this litigation, comparable investments were paying 8% to 14.5%; the guaranteed return of 4% was a poor incentive to choose a VALIC contract—unless the offer was coupled with a bonus, in this case, extra interest. VALIC offered that extra interest. It had to in order to be competitive for consumer dollars. In fact its fixed annuity plan can be characterized as a money market fund issued by an insurance company in direct competition with all other such investments. Though this was called a "fixed" account, in reality the return on it was almost as variable as the variable account itself.

VALIC sold its fixed annuity and variable annuity as one product. The selling literature and the documents relating to the investment program treated the fixed and the variable accounts as part of the same instrument. Separate documentation was not used for each type of account, since each account was freely convertible into the other. VALIC used the same confirmation which listed amounts allocated to both the fixed account participants and the variable account participants.

The Proceedings Below

Otto's complaint alleged causes of action under six counts: the Securities Act of 1934 for damages, not rescission, since rescission would not provide relief to the class for the failure to pay the interest VALIC had advertised it was paying; ERISA; RICO, conspiracy; common law fraud; and breach of contract. The district court

dismissed or granted summary judgment for VALIC on Otto's federal counts even though discovery and an opportunity to amend had both been denied.

Based on misleading representations (later found false) made by VALIC, the Court of Appeals initially affirmed the lower court. Otto then filed a Petition For Rehearing With Suggestions For Rehearing In Banc, pointing out in detail where VALIC had misled both the district court and the Court of Appeals. Otto would like to feel that the persuasiveness of her argument alone caused the court to reverse itself, but this may be incomplete. She had the assistance of VALIC's confession that it had misled the court.

After reviewing Otto's Petition for Rehearing and VALIC's confession of error, the Court requested further briefs and stated as follows in its order of January 29, 1987 (App. A):

> "Because VALIC's omission apparently involves a fact central to the analysis of a close question, VALIC's failure to disclose and subsequent motion to modify force this court to waste valuable judicial resources and may call for sanctions as well as possibly affecting the result." (p.4)

After filing of additional briefs on the issue of investment risk, the Court reversed as follows:

> "Upon reexamination in light of VALIC's newly asserted right to alter past interest bands, we hold that VALIC's fixed annuity plan is a security subject to the federal securities laws." (814 F.2d at 1141)

———o———

REASONS FOR DENYING THE PETITION

A. The Opinion of the Court of Appeals Does Not Conflict With Any Other Circuit, Any Prior Supreme Court Decision, The Standards Of The SEC, Will Not Have Immediate Or Widespread Consequences, Is Interlocutory In Nature, And Is Consistent With The McCarran-Ferguson Act And Other Regulatory Schemes.

1. The Opinion Does Not Conflict With Prior Decisions Of The Supreme Court Or Any Other Circuit.

The only circuit case VALIC lists as conflicting with the holding in the case at bar is *Olpin v. Ideal National Insurance Company,* 419 F.2d 1250 (10th Cir. 1969), cert. denied, 397 U.S. 1074 (1970). VALIC's reliance on *Olpin* is misplaced. *Olpin* involved a whole life insurance policy issued by a mutual company regulated by the state. In fact, in *Olpin* the Commissioner of Insurance for the state of Utah, based upon an opinion of the Attorney General that the Endorsement in question was void under the law of Utah, had approved various methods for the insurance company to return the premiums it had charged for the Endorsement (419 F.2d at 1252-3). *Olpin* did not involve providing the policy holder with an option to purchase a security; did not involve the hyping of excess interest; and was decided before SEC Release 6051 was issued in 1979 and SEC Rule 151 was adopted (1986). In oral argument VALIC admitted that the payments made by a mutual company to its policyholders are not similar to the discretionary interest payments in the case at bar (Oral Argument Transcript, p.14). In short, *Olpin* is no support for VALIC in the case at bar. Moreover, some eight years later it was not followed in *Grainger v. State Security Life Ins. Co.,* 547 F.2d 303, reh. denied, 563 F.2d 215 (5th Cir. 1977), cert. denied, 436 U.S. 932 (1978), which found a product similar to VALIC's fixed annuity a security.

It is significant that nowhere does VALIC claim a conflict with any court decision decided after SEC Release 6051 was issued in 1979. There is good reason for this. *No new law was established by the Court of Appeals here in its final decision.* The "traditional" securities-insurance cases have all been left untouched.

VALIC argues that its guarantee of 4% interest shifted the investment risk enough to qualify under Section 3(a)(8). The argument has been rejected by both the SEC (Release 6645) and the *Otto* Court of Appeals (814 F.2d at 1141-1142). The holding in the case at bar follows the teachings of the SEC and prior precedents of the 7th Circuit and this Court. In *Peoria Union Stock Yards Co. v. Penn Mutual Life Insurance Co.*, 518 F.Supp. 1302, 1306 (N.D.Ill. 1981), the opinion of the trial court found that the rate of interest credited on deposits made for the first three years of the contract was guaranteed at a rate of 7.5% and thereafter ultimately reduced to 3.5%. In commenting on the guarantee, Judge Posner in *Peoria Union Stock Yards Co. v. Penn. Mut. Life Ins. Co.*, 698 F.2d 320, 325 (7th Cir. 1983), first referred to the guarantee in the *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967), as a point of comparison and stated that:

> " '*United* set its guarantee by analyzing the performance of common stocks during the first half of the 20th century and adjusting the guarantee so that it would not have become operable under any prior conditions.' 387 U.S. at 209 n. 12, 87 S.Ct. at 1561 n.12. The minimum in the present case was even lower; . . ."

The *Peoria* court, in commenting that after the first three years of contributions the amount of interest was at the discretion of the insurance company, stated as follows:

> " . . . it was nonexistent for contributions made after the third year." (698 F.2d at 325)

In the case at bar, VALIC only guaranteed 4% interest for the first ten years of the contract and 3½% thereafter. The Court of Appeals followed prior precedent because the

guarantee given by VALIC is even less than the guarantee given by Penn Mutual discussed in the *Peoria* case (*supra*) and less than the guarantee in the *United Benefit* case (*supra*).

In short, the court merely applied the existing law relating to the securities-insurance dichotomy to the facts at hand. It added nothing new or extraordinary and is in accord with the case law, the SEC releases and SEC Rule 151.

2. The Opinion Does Not Conflict With SEC Rules Or Regulations Nor Has The SEC Filed An Amicus Brief In This Case.

Rule 151 was the banner waved by VALIC right up to the time the Court of Appeals reversed itself and held that VALIC did not comply with the rule. When faced with that outcome, VALIC now protests that the case should not turn on the objective investment risk test of Rule 151. Of all the grounds for holding the investment contract to be a security, Rule 151 was the most favorable for VALIC.

a. The Requirements Of Rule 151 Are The Most Liberal Of Any Previously Used By The SEC.

Otto points out that the great emphasis in this case on Rule 151 has come about because of VALIC's actions. As the Court stated:

> "Since Rule 151 was cited to us by VALIC as a relevant test, we are unwilling to ignore it to the degree urged by VALIC." (814 F.2d at 1142)

Of all the grounds available to VALIC for arguing that the investment products sold by it was insurance, none was so favorable as Rule 151. That rule, therefore, received a starring role in VALIC's briefs and arguments.

The SEC originally initiated an inquiry into annuities preparatory to issuing regulatory guidelines on June 23, 1977 (Release 5838). The insurance industry responded through its executives, attorneys and paid spokesman Pro-

fessor Louis Loss who VALIC now cites as authority throughout its Petition.[2] On May 17, 1978, the SEC issued Proposed Rule 154 (Release 5933) which in effect stated that all contracts such as the one in the case at bar were securities. After public comment, the SEC withdrew Proposed Rule 154 and issued Release 6051 (June 5, 1979) which required the insurer to have both a meaningful mortality and investment risk to qualify as exempt under Section 3(a)(8). VALIC does not qualify under either standard.

On November 21, 1984, the SEC then proposed Rule 151 in its Release 6558 and again after receiving comments from the insurance industry and taking two years consideration, the SEC further watered down its stand and issued Rule 151, which eliminated the mortality risk. In reviewing the conflicting positions taken in response to Release 6558, the SEC adopted the one year requirement [Rule 151(b)(3)] stating, "Designing a 'safe harbor' rule is essentially a matter of balancing the legitimate interests of flexibility in structuring insurance products against the need to provide adequate investor protection." (Release 6645, p.21) In summary, after retreating from its original position that all excess interest instruments were securities, the SEC has determined that unless a contract guarantees the excess rate of interest for a minimum of one year the purchaser/investor has the investment risk.

The determination of the SEC as to when the investor shoulders the investment risk should be given considerable weight. *United States v. National Association of Securities Dealers, Inc.*, 422 U.S. 694, 718-19 (1975). VALIC has admitted that they fail the SEC's objective investment risk

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[2] The court should be advised that Professor Loss has for some years been special counsel to the American Council of Life Insurance which has filed an Amicus Brief in this cause (L. Loss, *Fundamentals of Securities Regulation* (1983) at p. 213, footnote 1).

test of Rule 151 and the opinion in this case has confirmed the SEC's judgment.

Rule 151 is specific as to what is meant by assuming the investment risk under a contract. Among the requirements is that VALIC not be able to modify the rate of excess interest it pays more often than once a year (Rule 151b(3)). After being forced to file a new brief by the Court of Appeals on just the issue of what rights VALIC had to change the rate of excess interest it paid, and after admitting in its brief that it had the right to change the rate of excess interest daily, the Court of Appeals reversed. In reality, VALIC met none of the requirements of Rule 151 (see Point C-1 of this brief).

b. Objective Investment Risk Test Of Rule 151.

A primary focus of VALIC's Petition is that the Court's opinion is based on a new element: Section (b)(3) of Rule 151. Section (b)(3) of Rule 151 is an objective test, as determined by the SEC, as to when the investment risk shifts from the participant to the insurer, that being when the insurer guarantees that the excess interest rate will remain in effect for at least one year. In summarizing the prior case law and SEC regulations and rules, the opinion states:

> "As discussed in our previous opinion, the Supreme Court, this circuit, and the Securities and Exchange Commission (the 'SEC') all have found that the degree of investment risk assumed by the insurance company is an important factor in determining whether a particular annuity plan is an insurance product or a security." 814 F.2d at 1141.

In discussing the standards of Rule 151 the opinion stated as follows:

> "The SEC recently enacted Rule 151 which defines more precisely what constitutes sufficient investment risk-taking by an insurance company to ensure that an annuity will be considered an insurance product

> and exempt from federal securities laws pursuant to section 3(a)(8) of the 1933 Securities Act." *Id.*

And the Court held as follows:

> "A claimed right to change established excess interest rates and to eliminate excess interest payments entirely *at any time* surely tends to shift the investment risk from VALIC to the plan participant." *Id.* (emphasis added)

As the Court of Appeals recognized, if any investment risk to VALIC looked likely to occur all VALIC needed to do to eliminate its risk was lower the interest it paid on past "bands" as it did in December, 1983 (see R.131, lowered interest rate on past contributions).

VALIC had convinced the Court of Appeals that the investment risk test of Rule 151 was the guiding star. After doing so it had to confess that it could not meet the objective investment risk test of Rule 151. VALIC picked the arena in which it wanted to play; after losing, it then claimed it was the wrong arena. But as the Court said in its modified opinion, "Since Rule 151 was cited to us by VALIC as a relevant test, we are unwilling to ignore it to the degree urged by VALIC. We therefore find that VALIC's fixed annuity plan is a security." 814 F.2d at 1142.

c. VALIC Fails The Tests Of SEC Release 6051.

VALIC has admitted it fails the objective investment risk test of Rule 151. Although not discussed in the opinion, the policy of the SEC prior to Rule 151 and the policy in effect and which governs this case is Release 6051. This policy required both an investment risk and a mortality risk in order to be an exempt annuity.[3]

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[3] The SEC on April 5, 1979 issued its "General Statement of Policy" (Release No. 6051) giving the factors which differentiate a "security" from an "annuity" or "insurance product". Release 6051 provides as follows:

(Continued on following page)

The VALIC fixed annuity plan has no mortality risk. If an investor dies before purchasing an annuity or withdrawing his money all he obtains is his principal and the interest it earned. There is no mortality risk on VALIC.

VALIC states that its guarantee of 4% interest should qualify it as assuming an investment risk, evidently requesting this Court to overturn the lengthy deliberations of the SEC before it issued Rule 151; however, even before Rule 151, SEC Release 6051[4] provided that a contract

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(Continued from previous page)

"These risks are of two types—mortality risks and investments risks. A significant assumption of both kinds of risks is required, in the Commission's view, for a contract to be exempt pursuant to Section 3(a)(8) from the full disclosure and prospectus delivery requirements of the Act." (p.191)

"A contract which does not place upon the issuing insurance company a meaningful mortality risk cannot be regarded as 'life insurance' or an 'annuity' for purposes of the federal securities laws. A contract which does not impose meaningful mortality risks upon an insurance company is offered and purchased merely for investment, and purchasers of such contracts are entitled to the same protections, rights and remedies provided by the Act as to the purchasers of any other security which is offered and sold as an investment." (p.191)

[4] "Certain guaranteed investment contracts promise that a relatively low rate of interest will be credited on accumulating funds but also provide for crediting of discretionary excess interest, and the contract is sold by placing primary emphasis on the possibility that high discretionary interest will be credited. *In economic reality the insurer issuing such a guaranteed investment contract is asking the potential purchaser to assume the risk* that, after the expiration of an initial guarantee period during which high discretionary interest will be credited, interest to be credited will fall to the much lower guaranteed rate. Advertisements sponsored by insurance companies or authorized salespersons (such as broker-dealers) which emphasize high current discretionary excess interest and relegate mention of traditional annuity features to fine print must be viewed as *intended by the sponsors to encourage investment in guaranteed investment contracts principally by those investors who desire to assume the investment risk discussed above because their investment objective is to maximize tax-deferred capital accumulation rather than to acquire conventional annuity plans.*" (pp. 193-94, emphasis added)

such as VALIC's "fixed annuity", with its optional interest at the discretion of the issuer, was a security.

The SEC has not filed an amicus brief in this cause, confirming that the opinion does not conflict with any of its rules or regulations, unlike when the SEC was the petitioner in both *United Benefit* and *VALIC I*, where the lower courts did not follow its rules and regulations.

3. The Opinion Will Not Have Immediate Or Widespread Consequences.

This case arises out of the fraud and misrepresentations of VALIC in connection with the 403(b) annuity investment contracts sold by them. The case is important to VALIC and to Ott. But that is where its importance ends.

That, of course, is not the story told by VALIC, which seeks to cloak itself in the protection of the whole insurance industry. VALIC's Petition (and the Amicus Briefs) are replete with phrases like "enormous concern," "widespread adverse consequences," "substantial portion . . . thrown into jeopardy," " 'vital' importance," "significant changes," and other treasures of epic hyperbole.

VALIC attempts to do this by obfuscation. Throughout its brief VALIC calls its product "a traditional fixed annuity." A traditional fixed annuity is not what VALIC sold. It sold a product tailored to meet the unique benefits offered by the Internal Revenue Code to school teachers, nurses and other employees of nonprofit organizations. Nowhere does VALIC list the companies that sell similar Tax Deferred Investment Programs.

It is significant that VALIC never discloses the number of companies that sell 403(b) plans, nor the percentage of the industry sales these represent. Instead, VALIC orates in terms of the "industry," or a "major segment" of the industry. But only the VALIC 403(b) plan is affected by the decision in this case. The figures thrown about by VALIC deal with the industry as a whole, hoping to impress the court with large numbers. VALIC does

not even tell us the percentage or dollar amount of its business that these plans make up.

At least five fixed annuity contracts have already been registered with the SEC as securities. (ALI-ABA Conference on Life Insurance Company Products, "SEC Rule 151; Implications for SEC Regulation of Fixed Annuity Contracts and Other Insurance Products," p. 126, C189, 11/86). Hartford Life Insurance Company, one of the largest annuity sellers, registered its fixed annuity during the time SEC Release 6051 was in effect, which was just prior to the adoption of Rule 151. (Insurance Products Under the Securities Laws, 1985. PLI # B-4-6726.) VALIC's statements of exceptional importance are merely conclusions without factual backing.

The Petition takes the position that registration of fixed annuities with the SEC "will have widespread adverse consequences for the insurance industry, state insurance commissions, the SEC and policyholders." (Pet. 11) VALIC's position is contrary to the position of the insurance industry that was in effect in 1986 as the American Council of Life Insurance's Chief Counsel, Gary E. Hughes (and Amicus brief author), stated in his article before the ALI-ABA Conference on Life Insurance Company Products concerning Rule 151 registration of fixed annuity products as follows:

> "2. Disclosure Issues: For the most part, the disclosure format can be substantially similar to that used for variable annuity contracts. Principal differences would include S-K requirements in the following areas:"
>
> • • •
>
> "e. Note—*None of these have proven terribly burdensome,* but they are unique to the fixed an-

> nuity registration as opposed to the variable annuity because of the difference in the form used." (C189 *supra*, emphasis added).

VALIC also contradicts its own Amicus when it states that ". . . the companies also might have to conform to the requirements of the Investment Company Act of 1940, . . ." (Pet. p. 12). Otto's complaint does not allege a violation of the Investment Company Act of 1940. In the same article (C189, *supra*) Chief Counsel Hughes states as follows concerning insurance companies which issue fixed annuities which must be registered with the SEC as securities as follows at p. 127:

> "Most companies will not face the issue unless their sales of this product far outstrip sales of other products, but, in any event, substantial argument [can be made] that no 1940 Act registrations should be required merely because of the addition of an MVA, for example, to an otherwise traditional annuity contract."

The inconsistency of VALIC in its Petition before this Court and its own Amicus' prior positions published in a non-adversarial setting is obvious.

On Page 26 of its Petition VALIC implies that new rules under the NASD will now be applied to salesmen of this type of product. In fact, VAMCO, and its employees (only identified in the Petition as "VALIC's subsidiary" p. 3) who sold the product at issue were all registered as NASD representatives since they sold the admitted security, the variable account, as a combination contract with the fixed account (fixed annuity).

VALIC's assertion that ". . . relief under the Securities Act would nullify the actuarial determinations and risk-pooling arrangements on which the annuity plan is based" (Pet., p. 13) is false. Its product is a debtor-creditor instrument during the accumulation phase to which this case is addressed and there is no actuarial determina-

tion to be made unless the participant chooses to become an annuitant at retirement.

VALIC has not shown any other company that has misrepresented its product to the public the way VALIC here has or which would be affected by this decision. VALIC's variable annuity is registered with the SEC and the fixed annuity in the case at bar is merely an option attached to the variable. The only problem that this decision has for VALIC is that it will be liable for violations of the Securities Exchange Act of 1934 (fraudulent misrepresentations and omissions). Significantly, the thrust of this litigation is not for rescission, but for the interest that VALIC represented it would pay but failed to pay.

4. The Opinion Is Interlocutory In Nature.

The decision below is but one part, albeit an important part, of the case against VALIC. Untouched by the reversal are pleading matters and causes of action for breach of contract, fraud, conspiracy and RICO. The only cause of action to which the opinion is final is Otto's ERISA claim. No damages have been assessed. This is not the "extraordinary" case that warrants granting the Writ prior to final decree. See *Hamilton-Brown Shoe Co. v. Wolf Brothers & Co.*, 240 U.S. 251, 257-58 (1915). See also Conclusion of this brief *infra.*

What VALIC is really seeking is an advisory opinion overruling the determinations of the SEC. This request should be declined. The arguments raised by VALIC in its petition were all raised by the insurance industry, its spokesmen and its members before the SEC and were rejected. The SEC has determined that the guarantee of a low rate of interest is, alone, not sufficient to shift investment risk to the insurer to insulate it from the Securities Acts (Release 6645 at p. 27; Release 6051 at p.193-4; Release 6558; *Otto,* 814 F.2d at 1142)

5. The Opinion Is Consistent With The McCarran-Ferguson Act And Other Regulatory Schemes.

The Petitioners argue, at pages 23-28 of their Brief, "The Court of Appeals' Decision is Inconsistent with the Congressional Scheme of Exclusive State Regulation of Insurance." Petitioners raise the McCarran-Ferguson Act, 15 U.S.C. Sec. 1011 *et seq.*, as a bar to application of the federal securities acts to VALIC's fixed annuity program. This argument has been repeatedly rejected by this Court, as stated in *S.E.C. v. National Securities, Inc.*, 393 U.S. 453, 461 (1969):

> "Less than two years ago the Court approved the application of the registration requirements of the Securities Act of 1933, Sec. 5, 48 Stat. 77, 15 U.S.C. Sec. 77e, to certain annuity contracts issued by insurance companies. *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967). The Court explicitly rejected arguments based on the McCarran-Ferguson Act in a similar case of slightly earlier vintage. *SEC v. Variable Annuity Life Insurance Co.*, 359 U.S. 65, 67-68 (1959). Although the securities laws contain a number of exemptions relating to insurance and insurance companies, the Commission has traditionally regulated a number of activities related to insurance securities. Of course, under the securities laws state regulation may co-exist with that offered under the federal securities laws. [citations] *But is has never been held that state regulation of insurance securities pre-empts federal regulation, on the theory that the federal securities laws would be 'superseding' state laws regulating the 'business of insurance.'*" (emphasis added; footnotes and some citations omitted).

In sum, the Petitioners entire argument that state regulations of insurance companies pre-empts finding the product sold by VALIC to be a security is not the law. There is no reason to accept the very same argument in this case that has been rejected by this Court many times in the past.

Likewise, Petitioners reliance on the cases of *International Brotherhood of Teamsters v. Daniel,* 439 U.S. 551 (1979), *Landreth Timber Co. v. Landreth,* 471 U.S. 681 (1985), *Marine Bank v. Weaver,* 455 U.S. 551 (1981), *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462 (1977), and *Piper v. Chris-Craft Industries, Inc.,* 430 U.S. 1 (1977) is misplaced. These cases were cited for the proposition that any alternative regulation should pre-empt application of the Securities Acts. *Daniel* dealt with a non-contributory pension plan (the participant did not invest his own funds) which was regulated extensively by ERISA, unlike the fixed annuity plan in the case at bar which the Court of Appeals has held is exempt from ERISA regulation (814 F.2d at 1135). *Santa Fe* dealt with whether a dispute involving corporate mismanagement under state corporation law could be brought under the Securities Act. The court held that the fundamental purpose of the Act as implementing "a 'philosophy of full disclosure'; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute" (430 U.S. at 478), unlike the case at bar where the complaint is for failure to make any disclosure under the Securities Act. *Landreth* involved the sale of 100% of the stock of a business which was required to be registered with the SEC. *Piper* involved an attempt to extend the coverage of the Securities Acts to an unsuccessful takeover bidder. *Marine Bank* involved the application of federal banking laws which protected the investor and the Court therefore held that protection under the federal securities acts were unnecessary much like *Daniel's* which had applicable federal regulatory law available.

In short, none of the cases relied upon by VALIC involve the sale of unregistered securities to investors where no fraud protection exists except the Securities Acts; they only stand for the general proposition that when better protection is afforded the investor under

other federal regulatory schemes, the Securities Acts will not be extended. Such is not the issue in the case at bar. The only question is whether the fixed annuity plan with its unlimited option is a security.

B. The Petition Should Be Denied Because The Opinion May Be Affirmed On Grounds Not Discussed In The Opinion.

1. The Fixed Annuity Was An Admitted Option On An Admitted Security, The Variable Annuity.

Plaintiff has pointed out that VALIC offered a participant an *option* to switch from fixed to variable and vice versa. This option is found in the Owner's Manual (R.52, Ex.B), the Prospectus (R.52, Ex.C) and the Sales Literature (R.174, Ex.I). By determining that the fixed accumulation account (fixed annuity prior to the selection of a true annuity on retirement) sold by VALIC is a security because it contains an option on the variable annuity which is a security, the court would not have had to reach the question of whether it qualified as an insurance product under SEC Release 6051, SEC Rule 151 or even the Supreme Court cases of *VALIC I* or *United Benefit.* This unanswered issue alone resolves the question of whether the fixed annuity plan containing an option on the variable annuity is a security.

VALIC did not answer this issue in its Appellate brief, and admitted in oral argument before the Court of Appeals that an option to purchase a security is itself a security (Oral Arg. Trans., p.16)[5]. Such an admission

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[5] Judge Cudahy: "How about this aspect of convertability into the variable account—you don't answer that in your brief, I don't believe. That can be described as an option to purchase a variable product can't it?"

Randall Mitchell: "Well, your Honor it is no different than the array of options that any participant would have as to how to use his funds. The variable annuity is a registered security. *An option to purchase an interest in a security, the variable an-*

(Continued on following page)

constitutes a judicial admission which no longer may be controverted in the appeal. Graham, *Handbook of Fed. Evid.* (1981), Sec. 801.26; *Glick v. White Motor Co.*, 458 F.2d 1287, 1291 (3rd Cir., 1972). For an application of such admission in oral argument, see *Peoria Union Stock Yards Co. v. Penn Mutual Life Ins.*, 698 F.2d 320, at 322 (7th Cir. 1983).

This option was by no means free to the participant. VALIC charged a 5% fee on the first $5,000 of contributions and a lesser percentage down to 3½% on additional contributions regardless of whether the funds went into the fixed account or the variable account (R.174). Since money market accounts and mutual funds can be invested in without charge, the cost could only have been for the unlimited option to switch back and forth without cost.

Section 3(a)(10) of the Securities Act of 1934 (15 U.S.C. Sec. 78C) defines a security in part as follows:

> "... option or privilege on any security, ..." and "any ... warrant or right to subscribe to or purchase any of the foregoing" i.e., "investment contract" or "any instrument commonly known as a security."

An option on a security is a security. *See Mansback v. Prescott, Ball & Turben,* 598 F.2d 1017, 1026, fn. 40 (6th Cir. 1979); *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 750-51 (1975); Loss, "Fundamentals of Securities Regulation" (1983) pp. 250-258 (1986 Supp.); Loss, "Securities Regulation" (1961 Ed.) pp. 467-469 (1969 Supp.).

(Continued from previous page)

nuity, is a security just as I suppose an option to purchase a share of stock generally could be characterized as such, but that doesn't answer the question of what the character is of the fixed annuity. * * *" (emphasis added)

Judge Cudahy: "Well I don't quite follow that, because if you have an option to switch tracks on an ongoing basis every time you put in money aren't you purchasing an option to switch tracks at some later date?"

Although not mentioned in the opinion, the existence of the option is independent grounds for holding that the VALIC "Tax Deferred Investment Plan" and fixed annuity plan is a security.

2. The Case Deals With The Accumulation Phase Of The Fixed Annuity Which Is An Investment Contract Or Promissory Obligation.

An additional ground for holding that VALIC's fixed annuity is a security not mentioned in the opinion is that the attributes of the annuity must be examined with emphasis on the "accumulation phase", when it was a debtor-creditor instrument. Although not discussed in the opinion, it is proper to break down the VALIC fixed annuity program into its accumulation phase (at issue in this case) and its true annuity phase (if one is purchased). *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 210-211 (1967).

The question is, what is the proper definition of an investor's fixed accumulation account. Although not discussed in the opinion, during its accumulation phase it really constitutes a promissory obligation, as stated by VALIC in its handbook (R.52, Ex.B) (see *supra* Statement of Case at pp. 3-4). Thus, the account has all the attributes of a promissory obligation or "note" (*Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 [7th Cir. 1984]) or "transferable share", "certificate of deposit", or "certificate of interest or participation in any profit-sharing agreement", all of which are specifically included within the definitions of a "security" in the federal securities laws (15 U.S.C. 78[c]). This is another issue which VALIC refused to answer in any of its appellate briefs. Under *United Benefit* analysis, the VALIC fixed annuity plan is a security.

C. The Court Of Appeals Was Correct In Holding The VALIC Fixed Annuity Plan A Security And Subject To The Federal Securities Laws.

1. The Fixed Annuity Plan Fails All Tests Of The SEC And The Case Law.

a. VALIC Fails All Tests Of Rule 151.

While VALIC has admitted that it fails the SEC's objective investment risk test of Rule 151 (see Point A-2b of this brief), in reality, VALIC's product did not meet *any* of the Rule 151 tests.

(1) The Marketing Test of Rule 151.

VALIC also fails the marketing test of Rule 151 [(a)(3)]. Its fixed accumulation account (fixed annuity) is directly compared to IRA's and mutual funds. In addition, VALIC fails both standards set forth in Release 6558.[6] VALIC advertised the fixed account as follows: "VALIC endeavors to provide its participants in the Fixed Account with the highest current interest available." Further, the fixed accumulation account was sold as part of a combination contract which included the unlimited option to freely transfer any or all of the fixed account into the variable account (an admitted security) and thus was sold as "one type of tax-sheltered investment that is interchangeable with other such investments," contrary to Release 6558. The salespeople (VAMCO) were NASD members—not insurance salesmen. VALIC fails all tests promulgated by the SEC requiring the product not be

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[6] "The Commission recognizes it is difficult to identify precisely the circumstances under which a contract is being marketed primarily as an investment, since all annuity contracts contain some investment features. In the Commission's view, among the factors relevant to this determination are whether the contract is promoted (1) with substantial emphasis on current discretionary excess interest, and the possibility of future interest, or other investment-oriented features of the contract, and (2) as one type of tax-sheltered investment that is interchangeable with other such investments."

marketed primarily as an investment. See *Grainger v. State Security Life Ins. Co.*, 547 F.2d 303 (5th Cir. 1977), cert. denied, 436 U.S. 932 (1978).

(2) VALIC's Product Is Not Regulated By The State Of Illinois As Required By Rule 151.

Another test of Rule 151 [(a)(1)] for a security is whether there is "adequate" state regulation dealing with the particular product at hand. See SEC Releases 6558 and 6645 at p.6. The fixed annuity offered and sold by VALIC in Illinois is not specifically regulated by statute or regulation. (See Ill. Rev. Stat. ch. 73, sec. 613 et seq.; 50 Ill. Admin. Code sec. [Insurance]) 1 et seq. [1986]. This, and other elements dealing with investor protection, is precisely the lack of "adequate" state regulation focused on by Justice Brennan in his concurring opinion in *SEC v. VALIC*, 359 U.S. 65, 77-78 (1959). Compare this void for fixed annuities with Illinois' *specific* regulation of variable annuities tied to separate accounts, found at Ill. Rev. Stat. ch. 73, sec. 857.51-62, and at 50 Ill. Admin. Code sec. [Insurance] 1451.10-100.

VALIC can point to nothing in the record to support its claim that in Illinois its fixed annuity is specifically regulated by statute or regulations. In oral argument, VALIC's counsel could not identify any *specific* regulations, except an inaccurate statement that VAMCO's brokers are registered in the states where they sell the annuity. (See oral argument transcript pp. 17-18.) VAMCO is not registered to do business in Illinois (see Appellant's Brief, p.23 and Reply Brief, p.2). Because Illinois, like many other states, does not specifically regulate VALIC's fixed annuity, the product is a security under the tests of Rule 151 and prior SEC releases. See SEC Release 6558 (Rule

151); SEC Release 6050 (responding to commentary on proposed Rule 154).

The important point is this: No matter what criterion is looked to, what VALIC sold is a security. The decision in this case does not necessarily turn on Rule 151 or Release 6051. It *can* turn on these, but it does not matter which criterion is used because the result will always be the same. What VALIC sold is a security under each and every test that can be applied.

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CONCLUSION

No decision of any court of appeal, the Supreme Court or the SEC is, or has been shown by VALIC to be, in conflict with the opinion in the case at bar and no exceptional importance has been demonstrated.

VALIC has admitted that the status of this matter is technically interlocutory in nature. It is not necessary to grant its Petition to prevent extraordinary inconvenience or embarrassment in the conduct of the cause nor is the case of peculiar gravity or general importance. Obviously there is no criminal trial involved, no important jurisdictional questions present nor is there any pending injunction.

The absence of any unusual factors, as noted above, when combined with the interlocutory nature of this matter as it presently stands, and realizing that the denial of certiorari is without prejudice to renewal of issues that may be presented if and when certiorari is finally sought

from a final judgment, all mandate that VALIC's Petition for A Writ Of Certiorari should be denied.

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APPENDIX

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

January 29, 1987

Before

Hon. WILLIAM J. BAUER, Chief Judge

Hon. RICHARD D. CUDAHY, Circuit Judge

Hon. KENNETH F. RIPPLE, Circuit Judge

BEVERLY J. OTTO, individually, and on behalf of all others similarly situated, et al.,	)	Appeals from the United States District Court for the Northern District of Illinois, Eastern Division
Plaintiffs-Appellants,	)	
Nos. 85-1816, 85-1919 and 85-2410 v.	)	
	)	No. 82 C 4762
VARIABLE ANNUITY LIFE INSURANCE COMPANY, et al.,	)	Marvin E. Aspen, *Judge.*
Defendants-Appellees.	)	

ORDER

This order is in response to both the motion to modify the opinion submitted by the defendant, Variable Annuity Life Insurance Company (VALIC), and the plaintiff Otto's petition for rehearing.

In its motion to modify the opinion, VALIC requests that we delete from our opinion the following sentence: "Under this method, VALIC in effect guaranteed the ex-

cess interest rate on every deposit for the life of the annuity contract." VALIC claims that this statement is incorrect because VALIC had the right to change the interest rates paid on past contributions. According to VALIC, this right "necessarily" was included in VALIC's discretion to determine the excess interest rates paid on current contributions. VALIC argues that deleting the sentence would not affect the soundness of the opinion.

In its response to VALIC's motion, Otto agrees with VALIC that the sentence in question is factually incorrect. Otto, however, argues that the correctness of the sentence is crucial to the opinion's determination that the fixed annuity is not a security but an insurance product. Otto requests, both in its response to VALIC's motion and in its petition for rehearing, that we withdraw our entire discussion of this issue and find instead that the fixed annuity is a security.

We decline at this time to modify the opinion as requested by either party. It is far from obvious to us that VALIC's right to set the excess interest rate "necessarily" included the right to alter the interest "bands" paid on past contributions. In an affidavit submitted to the district court by VALIC, Larry E. Barnett, the Regional Manager for VALIC's Midwest Region and Vice-President of VAMCO, described the method by which interest was awarded under the fixed annuity, Defendants' Memorandum in Opposition to Plaintiff's Motion for Class Certification, Exhibit C. He stated, as is clear, that "[e]xcess interest over the guarantee may be paid in the sole discretion of the Company's Board of Directors." *Id.* He explained, however, that these discretionary changes in the excess interest rate affected only current, and not past,

contributions: "[I]nterest on the fixed annuity is calculated by the 'new money' method, meaning that changes, up or down, in excess interest rates affect only monies contributed during the current period. This practice . . . is sometimes referred to as 'banding' . . . ." *Id.*

Attached to the affidavit was a question and answer which, according to Mr. Barnett, was included in a formal written proposal sent to "virtually all, if not all, prospective customers" in the Midwest Region during the years 1979 to 1983. *Id.* That question and answer read as follows:

> Describe the basis for the dividends or current interest rate illustrated above.
>
> The current rate of interest is composed of the guaranteed interest rate plus "excess interest." Excess interest is declared and guaranteed for deposits received in the Fixed Account on a calendar quarter basis by the Board of Directors of VALIC. Excess interest is computed daily and credited on amounts remaining in a participant's Fixed Account at the end of each calendar quarter.
>
> VALIC employs the new money method for crediting excess interest. The current interest rate is paid on monies for the period in which it is in effect. *Should the current interest rate change (i.e., up or down), it would not affect a participant's past contributions but only those contributions deposited while the new rate is in effect.* A change in the current rate would in no way affect the past accumulations in a participant's account balance.

Id. (emphasis added).

There is no indication in either the affidavit or the question and answer submitted with the affidavit that VALIC had the authority to change the interest rates banded to past contributions. Indeed, VALIC's repeated

assertions that its discretion to determine the excess interest rate in no way affected the interest paid on past contributions suggests that VALIC did not have the authority to alter the "bands" of interest rates. At the very least, these statements were likely to mislead prospective customers, and this court, into believing that the bands were guaranteed.

On appeal before this court, VALIC did nothing to correct this possibly incorrect impression it had created before its potential customers and the district court. In its brief, VALIC described the fixed annuity as follows:

> Like virtually all of its competitors at that time, VALIC employed the "new money" or "banding" method for crediting excess interest to the fixed annuity account; *i.e.*, the excess interest rate set by the Board of Directors was paid on deposits made during that particular period. Subsequent fluctuations in the excess rate did not affect a participant's past contributions. Each deposit stayed in its "band," and continued to draw interest at the rate in effect when the deposit was made.

Defendants' Brief at 4-5 (footnote omitted). Again, in this description of the fixed annuity, VALIC stressed that its changes in the excess interest rate did not affect past contributions, which would remain in their bands.

In a footnote to this discussion, VALIC does indicate that it "modified its interest-crediting practice" subsequent to the end of Otto's participation in the fixed annuity plan. *Id.* at 4 n.4. This footnote refers to a letter included in the appendix to Otto's brief. The letter, however, deals primarily with VALIC's decision to guarantee the excess interest rate paid on new deposits for one year,

a decision unrelated to the interest rates for past contributions.[1] The letter also lists the interest rates applicable to past contributions. As Otto points out in her petition for rehearing, this list "reduced the prior banded interest rates from 1982 which were as high as 14.5% down to 13%." Plaintiff's Petition for Rehearing at 12. Yet this fact, that VALIC was for the first time attempting unilaterally to reduce a banded interest rate, is not disclosed in the letter and can be deduced only with the possession of independent knowledge of what the bands were prior to the letter.

If VALIC did, in fact, have the right to reduce the banded interest rates, our determination that the fixed annuity was an exempt insurance product not subject to the federal securities laws may be flawed. Whether VALIC possessed this discretion certainly is important to the level of investment risk assumed by VALIC. In addition, our opinion relied in part on the fixed annuity's satisfaction of all of Rule 151's "safe harbor" requirements. One of those requirements apparently would not be met if VALIC had the authority to change the interest bands. The failure of the fixed annuity to qualify for safe harbor treatment under Rule 151 would not require us to find that the fixed annuity was a security, both because the Rule technically does not cover annuities for the time period in question and because the rule does not purport to provide

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[1] The letter incorrectly states that the excess interest rate is paid on past as well as new deposits: "As in the past, excess interest is determined at the discretion of VALIC's Board of Directors and is computed on the basis of amounts remaining on deposit in your fixed account at the end of each calendar quarter."

an all-inclusive definition of all annuities that are exempt from the federal securities laws. Nevertheless, the failure of the fixed annuity to satisfy any prong of Rule 151 clearly is relevant to and requires a reevaluation of the status of the annuity.

Before deciding finally whether or not to modify our opinion, we feel it is appropriate to allow the parties to submit further briefs on this issue. The briefs should be directed at explaining more fully both the extent of VALIC's authority to alter the interest rates, including those paid on past contributions, and whether, in light of that authority, the fixed annuity is properly viewed as a security or insurance. We also direct VALIC to explain to this court why, when describing its banding method of computing interest, it did not inform the court that VALIC claimed to have the discretion to alter the bands assigned to past contributions. This failure seems to us to be clearly misleading. Because VALIC's omission apparently involves a fact central to the analysis of a close question, VALIC's failure to disclose and subsequent motion to modify force this court to waste valuable judicial resources and may call for sanctions as well as possibly affecting the result.

VALIC, therefore, is directed to file a brief not more than 20 pages in length by February 13, 1987. Otto may file an answering brief not more than 20 pages in length by March 2, 1987.